

## § 1.121-5

## 26 CFR Ch. I (4-1-09 Edition)

1 through 1.121-4 for any years for which the period of limitation under section 6511 has not expired. The taxpayer makes the election under this paragraph (j) by filing a return for the taxable year of the sale or exchange that does not include the gain from the sale or exchange of the taxpayer's principal residence in the taxpayer's gross income. Taxpayers who have filed a return for the taxable year of the sale or exchange may elect to apply the provisions of these regulations for any years for which the period of limitation under section 6511 has not expired by filing an amended return.

(k) *Audit protection.* The Internal Revenue Service will not challenge a taxpayer's position that a sale or exchange of a principal residence occurring before December 24, 2002 but on or after May 7, 1997, qualifies for the section 121 exclusion if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 121. Compliance with the provisions of the regulations project under section 121 (REG-105235-99 (2000-2 C.B. 447)) generally will be considered a reasonable, good faith effort to comply with the requirements of section 121.

(l) *Effective date.* This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions retroactively, see paragraph (j) of this section.

[T.D. 9030, 67 FR 78361, Dec. 24, 2002; 68 FR 6350, Feb. 7, 2003]

### **§ 1.121-5 Suspension of 5-year period for certain members of the uniformed services and Foreign Service.**

(a) *In general.* Under section 121(d)(9), a taxpayer who is serving (or whose spouse is serving) on qualified official extended duty as a member of the uniformed services or Foreign Service of the United States may elect to suspend the running of the 5-year period of ownership and use during such service but for not more than 10 years. The election does not suspend the running of the 5-year period for any period during which the running of the 5-year period with respect to any other property of the taxpayer is suspended by an election under section 121(d)(9).

(b) *Manner of making election.* The taxpayer makes the election under section 121(d)(9) and this section by filing a return for the taxable year of the sale or exchange of the taxpayer's principal residence that does not include the gain in the taxpayer's gross income.

(c) *Application of election to closed years.* A taxpayer who would otherwise qualify under §§ 1.121-1 through 1.121-4 to exclude gain from a sale or exchange of a principal residence on or after May 7, 1997, may elect to apply section 121(d)(9) and this section for any years for which a claim for refund is barred by operation of any law or rule of law by filing an amended return before November 11, 2004.

(d) *Example.* The provisions of this section are illustrated by the following example:

*Example.* B purchases a house in Virginia in 2003 that he uses as his principal residence for 3 years. For 8 years, from 2006 through 2014, B serves on qualified official extended duty as a member of the Foreign Service of the United States in Brazil. In 2015 B sells the house. B did not use the house as his principal residence for 2 of the 5 years preceding the sale. Under section 121(d)(9) and this section, however, B may elect to suspend the running of the 5-year period of ownership and use during his 8-year period of service with the Foreign Service in Brazil. If B makes the election, the 8-year period is not counted in determining whether B used the house for 2 of the 5 years preceding the sale. Therefore, B may exclude the gain from the sale of the house under section 121.

(e) *Effective date.* This section is applicable for sales and exchanges on or after May 7, 1997.

[T.D. 9152, 69 FR 50306, Aug. 16, 2004]

### **§ 1.122-1 Applicable rules relating to certain reduced uniformed services retirement pay.**

(a) *Rule applicable prior to January 1, 1966.* In the case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)) who has made an election under Subchapter I of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431)) to receive a reduced amount of retired or retainer pay, gross income shall include the amount of any reduction made in his retired or

retainer pay before January 1, 1966, by reason of such election, unless such reduction, or portion thereof, is otherwise excluded from gross income under Part III of Subchapter B of Chapter 1 of the Internal Revenue Code of 1954 or any other provision of law.

(b) *Rule applicable after December 31, 1965*—(1) In a case of a member or former member of the uniformed services of the United States (as defined in 37 U.S.C. 101(3)), gross income shall not include the amount of any reduction made in his or her retired or retainer pay after December 31, 1965, by reason of—

(i) An election made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), or

(ii) The provisions of Subchapter II of Chapter 73 of Title 10 of the U.S. Code (also referred to in this section as the Survivor Benefit Plan (10 U.S.C. 1447)).

(2)(i) In a case where a member or former member of the uniformed services has, pursuant to the election described in paragraph (a) of this section, received before January 1, 1966, a reduced amount of retired or retainer pay, he shall, after December 31, 1965, exclude from gross income under section 122(b) and this subdivision all amounts received as uniformed services retired or retainer pay until there has been so excluded an amount of retired or retainer pay equal to the "consideration for the contract" (as described in subdivision (iii) of this subparagraph).

(ii) Upon the death of a member or former member of the uniformed services, where the "consideration for the contract" (as described in subdivision (iii) of this subparagraph) has not been excluded in whole or in part from gross income under section 122(b) and subdivision (i) of this subparagraph, the survivor of such member who is receiving an annuity under Chapter 73 of Title 10 of the U.S. Code shall, after December 31, 1965, exclude from gross income under section 72(o) and this subdivision such annuity payments received after December 31, 1965, until there has been so excluded annuity payments equalling the portion of the "consideration for the contract" not previously excluded under subdivision (i) of this subparagraph.

(iii) The term "consideration for the contract" as used in this subparagraph means—

(a) The total amount of the reductions, if any, before January 1, 1966, in retired or retainer pay by reason of an election under Subchapter I of Chapter 73 of Title 10 of the United States Code, plus

(b) The total amount, if any, deposited by the serviceman at any time pursuant to the provisions of sections 1438 or 1452(d) of Title 10 of the United States Code, plus

(c) The total amount, if any, excludable from income under section 101(b)(2)(D) and paragraph (a)(2) of § 1.101-2 with respect to a survivor annuity provided by such retired or retainer pay, minus

(d) The total amount, if any, excluded from income before January 1, 1966, pursuant to the provisions of section 72 (b) and (d) with respect to a survivor annuity provided by such retired or retainer pay.

(iv) In determining whether there has been a recovery of the "consideration for the contract" under subdivision (i) of this subparagraph, the exclusion of retired pay from income after December 31, 1965, under sections 104(a)(4) and 105(d) shall not be considered as recovery of all or part of the "consideration for the contract."

(c) *Special rules.* In any of the following situations, the computation of the excludable portion of disability retired pay received by the member or former member of the uniformed services shall be governed by the following rules:

(1) An exclusion under section 122(a) and paragraph (b)(1) of this section is applicable only in the taxable year in which a reduction in retired pay is made under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(2) Where the member or former member of the uniformed services is entitled to exclude the whole or a portion of his retired pay under the provisions of section 104(a)(4) or section 105(d) and under section 122(a) and

paragraph (b)(1) of this section, the exclusion under section 122(a) and paragraph (b)(1) of this section shall be applied prior to the exclusions under sections 104(a)(4) and 105(d).

(3) Where the member or former member of the uniformed services waives a portion of his disability retired pay, or such retired pay reduced under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), or the Survivor Benefit Plan (10 U.S.C. 1447) in favor of a nontaxable pension or compensation receivable under laws administered by the Veterans Administration (38 U.S.C. 3105), the waived amount of such disability retired pay, or reduced amount thereof, shall first be subtracted from any amounts which are excludable under the provisions of sections 104(a)(4) or 105(d) so as to reduce the amounts otherwise excludable under those sections.

(4) Where the member or former member of the uniformed services receives (before any forfeiture) disability retired pay (whether or not reduced under the Retired Serviceman's Family Protection Plan) or the Survivor Benefit Plan which is partially excludable under section 104(a)(4), and also forfeits a portion of such disability retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5531 or any former corresponding provision of law), the amount of the forfeiture under such Act shall be applied against disability retired pay (before any forfeiture) in the same proportion that the excludable portion of such pay under section 104(a)(4) bears to the total amount of such pay after subtraction of any reduction under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) or the Survivor Benefit Plan (10 U.S.C. 1447).

(5) The exclusion provided by section 122(b) and paragraph (b)(2)(i) of this section shall be available with respect to repayments made upon removal from the temporary disability retired list even though such repayments were previously excluded from gross income under section 104(a)(4) or 105(d).

However, the exclusion permitted by the prior sentence will apply only to the extent the repaid amount has not been previously excluded under section

122(b) and paragraph (b)(2)(i) of this section.

(d) *Examples with respect to the Retired Serviceman's Family Protection Plan.* The rules discussed in this section relating to the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) may be illustrated by the following examples:

*Example 1.* A, a member of the uniformed services, retires on January 1, 1963, and receives nondisability retired pay computed to be 60 percent of his active duty pay of \$10,000 per year, or \$6,000 per year, based upon 24 years of service. He elects, under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431), to provide his survivor with an annuity equal to one-fourth of his reduced retired pay. His retired pay of \$6,000 is reduced by \$600, to \$5,400, in order to provide a survivor annuity of \$1,350 per year or \$112.50 per month. For 1963, 1964, and 1965, A must include in gross income the unreduced amount of retired pay, or \$6,000. For 1966 and subsequent years, he may exclude under section 122(a) and paragraph (b)(1) of this section the \$600 total annual reductions to provide the survivor annuity, and may, for 1966, further exclude from gross income under section 122(b) and paragraph (b)(2)(i) of this section the \$1,800 "consideration for the contract" *i.e.*, the total reductions which were made in 1963, 1964, and 1965, to provide the survivor annuity. Accordingly, A will include \$3,600 of retired pay in gross income for 1966 (\$6,000 minus the sum of \$600 and \$1,800).

*Example 2.* Assume the facts in Example (1) except that A retires on disability resulting from active service and his disability is rated at 40 percent. The entire amount of disability retirement pay, prior to and including 1966, is excludable from gross income under sections 104(a)(4) and 105(d), and in 1966, section 122(a). Assume further that A attains retirement age on December 31, 1966, dies on January 1, 1967, and his widow then begins receiving a survivor annuity under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431). A's widow may exclude from gross income in 1967 and 1968 under section 72(o) and paragraph (b)(2)(ii) of this section, the \$1,800 of "consideration for the contract" *i.e.*, the reductions in 1963, 1964, and 1965 to provide the survivor annuity. Thus, A's widow will exclude all of the survivor annuity she receives in 1967 (\$1,350) and \$450 of the \$1,350 annuity received in 1968. In addition, if A had not attained retirement age at the time of his death, his widow would, under section 101 and paragraph (a)(2) of § 1.101-2, exclude up to \$5,000 subject to the limitations of paragraph (b)(2)(ii) of this section.

*Example 3.* Assume, in the previous example, that A dies on January 1, 1965, and his

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widow then begins receiving a survivor annuity. Assume further that A's widow is entitled to exclude under section 72(b) \$1,000 of the \$1,350 she received in 1965. Under section 72(o) and paragraph (b)(2)(ii) of this section, A's widow for 1966 will exclude the \$200 remaining consideration for the contract (\$1,200 - \$1,000) and will include \$1,150 of the survivor annuity in gross income.

**Example 4.** B, a member of the uniformed services, retires on January 1, 1966, after 32 years of active military service, and receives disability retirement pay under section 1401 of title 10, limited to 75 percent of his active duty pay of \$15,000 per year, or \$11,250. His disability rating is 30 percent. B has not reached retirement age (as defined in § 1.79-2(b)(3)). He elects under the Retired Serviceman's Family Protection Plan (10 U.S.C. 1431) to provide his survivor with an annuity equal to one-half of his reduced retired pay and, for that purpose, his retired pay of \$11,250 is reduced by \$1,250 to provide an annuity of \$5,000 per year. B also elects to waive retired pay in the amount of \$1,000 in order to receive disability compensation in like amount under laws administered by the Veterans Administration. In addition, B is required to forfeit \$4,088 of his retired pay under the Dual Compensation Act of 1964 (5 U.S.C. 5532) (\$11,250 - \$1,000 = \$10,250 less one-half of excess thereof over \$2,074) and by reason of his Federal employment is not entitled to an exclusion of his retired pay under section 105(d). B's taxable retired pay for 1966 is \$3,002, computed as follows:

Gross retired pay .....	\$11,250
Less: Section 122(a) exclusion .....	(1,250)
Reduced retired pay .....	10,000
Less: Retired pay waived to receive V.A. compensation .....	(1,000)
Adjusted retired pay—	9,000
Less:	
(i) Excludable retired pay computed under section 104(a)(4) as limited by 10 U.S.C. 1403 .....	\$4,500
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation .....	(1,000)
(iii) Net disability exclusion .....	(3,500)
Taxable retired pay before adjustment for Dual Compensation forfeiture .....	5,500
Less:	
Adjustment for Dual Compensation forfeiture of \$4,088	
$5500 \div 9000 \times \$4,088 = \$2,498$ (rounded) .....	(2,498)
Net taxable retired pay .....	3,002

**Example 5.** C, a member of the uniformed services retires on January 1, 1966, and receives disability retirement pay of \$11,250 per year, which is reduced by \$1,250 to provide a survivor annuity, and \$1,000 of which is waived in order to receive disability compensation in like amount under laws administered by the Veterans Administration. C has not reached retirement age for purposes

of section 105(d) and is not employed by the Federal Government. C's taxable disability retirement pay for 1966 is \$300 computed as follows:

Adjusted retired pay .....	\$9,000
Less:	
(i) Excludable retired pay under section (a)(4) as limited by 10 U.S.C. 1403 .....	\$4,500
(ii) Excludable retired pay under section 105(d) .....	5,200
(iii) Total .....	9,700
(iv) Less: Retired pay, not to exceed (iii), waived to receive V.A. compensation "sick pay" exclusion .....	(1,000)
(v) Net disability and "sick pay" exclusion .....	(8,700)
Net taxable retired pay .....	800

**Example 6.** D, a member of the uniformed services, retires for physical disability resulting from active service on January 1, 1966, after 35 years of service and with a disability rated at 20 percent. His active duty pay is \$4,000 per year and he attained retirement age prior to retirement. He had an election in effect under the Retired Serviceman's Family Protection Plan to provide his survivor with an annuity and his retired pay is reduced therefor by \$500 per year. He waives \$1,300 of his retired pay in order to receive compensation from the Veterans Administration in like amount. His taxable retired pay for 1966 is \$1,200 computed as follows:

Gross retired pay (75% × \$4,000) .....	\$3,000
Less: Section 122(a) exclusion .....	(500)
Reduced retired pay .....	2,500
Less: V.A. waiver .....	(1,300)
Adjusted retired pay .....	1,200
Less:	
(i) Section 104(a)(4) exclusion .....	\$800
(ii) Less: Retired pay, not to exceed (i), waived to receive V.A. compensation .....	(800)
(iii) Net disability exclusion .....	0
Net taxable retired pay .....	1,200

(e) *Principles applicable to the Survivor Benefit Plan.* The principles illustrated by the examples set forth in paragraph (d) of this section apply to an annuity under the Survivor Benefit Plan (10 U.S.C. 1447).

[T.D. 7043, 35 FR 8478, June 2, 1970, as amended by T.D. 7562, 43 FR 38819, Aug. 31, 1978]